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Review of WACC parameters: Gamma

ETSA Price Reset

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1 Overview

1.1 Formulation of gamma

The estimated cost of corporate income tax of a *Distribution Network Service Provider* (**DNSP**) for each *regulatory year* is calculated in accordance with the following formula:

$$(ETC_t) = (ETI_t \times r_t)(1 - \gamma)$$

The γ represents the assumed utilisation of imputation credits.

It is noted by SFG Consulting[1] that there are two components to the γ. This can be expressed as follows:

$$\gamma = F \times \theta$$

where:

F = the distribution rate, or the rate at which franking credits that are created by the relevant firm are distributed to shareholders, attached to dividends; and

θ = the value to investors of a franking credit at the time they receive it

1.2 Franking credits distribution rate

The Australian Energy Regulator (AER) conducted a review of the weighted average cost of capital (WACC) parameters to be adopted in determinations for electricity transmission and DNSPs.

In the course of the review, the AER sought the view of John C Handley of the University of Melbourne on the valuation of imputation credits. In relation to the distribution rate, Handley stated:

> *"It is unreasonable to assume that such a build up of credits would not (eventually) attract the attention of investors, investment bankers and or potential corporate raiders. Further, when assessing the likelihood of eventual distribution of retained imputation credits, one should not restrict their thinking to existing mechanisms, schemes, structures and securities, for history has shown that financial markets are highly innovative when the incentives are large."* [2]

In other words, when assessing the value of F, Handley assumes that <u>all</u> imputation credits are eventually distributed and that irrespective of the perceived impediments, financial markets will, if sufficiently incentivised, find a way to distribute all imputation credits.

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[1] SFG Consulting, 'The impact of franking credits on the cost of capital of Australian firms' dated 16 September 2008, at [3].

[2] John C Handley, 'Further Comments on the Valuation of Imputation Credits' dated 15 April 2009 (**Handley Supplementary Report**), at 8.

Handley's view is incorrect in the context of establishing the WACC. Whilst it is not possible to say that entities will never engage in "schemes" and "structures" to facilitate the eventual distribution of franking credits, the income tax law presents significant impediments to full, effective distribution of franking credits. [3] Furthermore, Treasury has in the past shown a readiness to not only adopt further specific measures to prevent these forms of schemes, but will sometimes do so retrospectively.

This paper demonstrates that in practice it is not "a given" that companies can effectively distribute retained franking credits. The effect and design of the imputation rules is such that the very policy and stated objective of the imputation rules is to ensure some credits are 'wasted' – that is not used or distributed. The mechanisms in the tax law described in this paper seek to give effect to this stated objective.

Furthermore, Handley's statement above disregards non-tax considerations associated with distributions. While a detailed analysis of non-tax considerations is beyond the scope of this paper, we make the following observations. The assumption that a company will distribute all franking credits is not consistent with all commercial practices. Commercial imperatives mean that companies may not be in a position to fully distribute all of their retained franking credits. In the case of franking credits attached to dividends paid on ordinary shares, a firm's retained earnings are often a significant practical consideration. A reduction in retained earnings will alter a company's capital structure. This could have significant implications and could influence the ability of a company to raise further capital. It is also significant that the AER's statement of regulatory intent assumes that a regulated business maintains a constant level of gearing.

It should also be noted that shareholder preferences place another important restriction on the ability of a company to distribute retained credits, such as a preference for capital gains rather than franked dividends (refer to section 4 for further commentary on this last point).

The discussion below describes the key impediments that currently exist in the income tax law, as well as their practical relevance to this issue.

2 The benchmark rule

A key element of imputation is the benchmark rule. This rule affects the quantum of credits available for distribution and may, in certain situations, result in a loss of franking credits.

2.1 Benchmark rule

Under the imputation system, a corporate tax entity is limited in its capacity to determine the extent to which it will frank a frankable distribution by the maximum franking credit rule[4] and the **benchmark rule**.[5] The benchmark rule provides that all frankable

[3] In particular, the *Income Tax Assessment Act 1936* (**ITAA36**) and *Income Tax Assessment Act 1997* (**ITAA97**).

[4] Section 202-60 of the ITAA97 creates a formula for the maximum franking credit which may be attached to a frankable distribution as: [the amount of the frankable distribution x 3/7].

[5] Certain publicly listed companies (or subsidiaries of such companies) are exempt from the benchmark rule under s 203-20(1). The publicly listed company must also satisfy the criteria that: (a) they cannot make a distribution on one membership interest during the franking period without making a distribution under the same resolution on all other membership interests; and (b) the company cannot frank a distribution made on one membership interest during the franking period without franking

distributions made during a particular franking period (there are generally two equal franking periods within the tax year for a public company) must be franked to the same extent (s 203-35, ITAA97).

The benchmark rule therefore severely curtails the capacity of companies to stream franking credits to members who are best able to use them and is bolstered by a number of anti-avoidance measures, discussed below.

The Explanatory Memorandum to the *New Business Tax System (Imputation) Act 2002* (Cth) states:

> *3.7 To gain a full understanding of the anti-streaming rules it is necessary to understand the underlying policy.*
>
> *3.8 Where members hold interests in the profits of a corporate tax entity, the policy is that credits for tax paid on behalf of all members should flow to all members and not to only some of them...the policy of the tax law assumes that the benefit of imputation will, over time, be spread more or less evenly across members in proportion to their holdings in a corporate tax entity, having regard to any particular rights that attach to those holdings.*
>
> *3.9 A consequence of generally spreading imputation benefits evenly across members is that members who cannot use, or cannot fully use, imputation benefits will nevertheless receive franked distributions. This results in the 'wastage' of those benefits, which is a design feature of the imputation system. Wastage of imputation benefits also includes the failure to use franking credits attributable to profits that are never distributed.*
>
> *3.10 The benchmark rule and the anti-streaming rules ensure that the intended wastage of imputation benefits is not undermined.*

An Explanatory Memorandum is not law, and does not have the force of law. However, it is valuable for use in interpretation of the law by providing the context to provisions and describing the particular circumstances for which the provision was enacted. It is therefore often referred to by tax practitioners as one of the clues for the likely approach the Courts and the ATO may adopt in interpreting provisions or in seeking guidance as to their practical application.

2.2 ATO supervision

In addition to the general auditing processes undertaken by the ATO, subdivision 204-E (ITAA97) contains a disclosure rule to support the benchmark rule and anti-streaming rules.

The disclosure obligations will be triggered when the benchmark franking percentage for the current franking period 'differs significantly' from the benchmark set for the last relevant franking period (ie, the last franking period in which the entity made a frankable distribution). Under s 204-75(2), there will be a significant difference between the benchmarks where there is a variation of more than 20 percentage points. For each

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distributions made on all other membership interests under the same resolution with a franking credit worked out using the same franking percentage.

intervening franking period in which no frankable distribution is made, the maximum non-reportable variation increases by an additional 20 percentage points. Note also that a frankable distribution includes deemed dividends (per ss 202-40 and 960-120).

This regime allows the ATO further opportunity to scrutinise the franking activities of entities and ensure they are not breaching the benchmark rule or any of the anti-avoidance measures, and needs to be disclosed on the franking account return which accompanies a company's annual tax return.

3 Technical impediments to complete realisation of imputation credits

The Table below sets out a summary of the key measures intended to restrict the capacity for companies to stream and distribute imputation credits to certain shareholders, or to avoid the franking benchmark rule.

Effect of provision
Breach of benchmark rule
Under-franking (s 203-50 ITAA97) Where an entity makes a frankable distribution with a franking percentage less than the entity's benchmark franking percentage for the franking period, an additional franking debit will arise in the company's franking account to the extent of the difference. The ability to 'distribute retained credits at will' is subject to the benchmark rule which, together with the anti-avoidance rules discussed below, greatly restrict the capacity for a company to distribute retained credits. Under-franking, for example, will cause a permanent loss of a portion of the retained credits of the company before they are actually distributed.
Anti-streaming rules
As discussed in section 2 above, the benchmark rule creates a framework for ensuring that the benefit of franking credits are spread evenly across members in proportion to their ownership interest in the entity, regardless of the wastage this creates. A number of anti-streaming rules have developed over the past two decades to prevent the undermining of this framework. The importance of these provisions is that if companies seek to undermine the "wastage" concept, they risk permanently forfeiting franking credits. In addition to the impediments for streaming of franking credits, we note that neither the Handley Report nor the Handley Supplementary Report consider the consequences of breaching the rules – namely the permanent forfeiture of franking credits. **Linked distributions** (s 204-15 ITAA97) This provision applies to streaming arrangements involving linked distributions, where a member of an entity (the first entity) chooses to receive a distribution from a second entity that is franked to a greater or lesser extent than distributions made to

Effect of provision
other members of the first entity. Contravention of the rule results in a debit arising in the franking account of the entity with the higher benchmark franking percentage. This rule would apply, for example, where stapled stock arrangements are used for streaming by allowing holders to choose to receive either franked or unfranked dividends depending on the company paying the dividend. **Substitution of tax-exempt bonus shares** (s 204-25 ITAA97) This provision applies to streaming arrangements involving tax-exempt bonus shares, where a member of the entity chooses to have tax-exempt bonus shares issued to the member or another member of the entity, instead of receiving a franked dividend. Contravention of the rule results in a penalty franking debit to the entity's franking account. This would apply where the substituted shares in a listed company are provided without any credit in the company's share capital account. **Streaming distributions** (subdiv 204-D ITAA97) This provision applies to arrangements where an entity streams distributions to provide imputation benefits to members who benefit more from imputation credits than other members. The Commissioner may apply sanctions including debits to the franking account of the entity and denial of imputation benefits to a favoured member where this rule is breached. The Explanatory Memorandum[6] provides the example of a non-resident controlled company with residency minority shareholders. The company would infringe the provision by distributing all of its franking credits to the minority shareholders whilst retaining the share belonging to the controlling shareholder in the company, with a view to ultimately paying an unfranked dividend (or other benefit) to the majority shareholder. Contrary to John Handley's view,[7] the accumulation of franking credits would have limited value to investors where they would need to accept the wastage of credits paid to other investors (who may be non-resident for instance) because of the inability to stream franking credits.
Exempting entities (Div 208 ITAA97)
These provisions limit the franking benefits available to members who receive franked distributions from entities which are effectively owned by non-residents or tax exempt entities. They also quarantine the franking surpluses of entities which were formerly effectively owned by non-residents or tax exempt entities (former

[6] To the *New Business Tax System (Imputation) Bill 2002.*

[7] Handley Supplementary Report, page 8.

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exempting entities). Exempting entities and former exempting entities are generally not in a position to pass on the benefit of accumulated franking credits, the provisions are aimed at preventing such entities from paying franked distributions to resident members.
Schemes to provide capital benefits (s 45C ITAA36)
This section empowers the Commissioner to impose franking debits on a company where a determination has been made pursuant to s 45B. The purpose of these measures is to ensure that provision of capital benefits in substitution for dividends are treated as dividends for taxation purposes. By making a relevant determination, the Commissioner can require a company to forfeit franking credits. These provisions act as a complement to the share capital tainting provisions discussed below.
Qualified persons to use franking credits (s 207-145 ITAA97)
An entity is not entitled to take advantage of a franking credit where they are not a qualified person for the purposes of Division 1A of the former Part IIIAA (ITAA36) which provides, inter alia, that the member has held the shares 'at risk' for a continuous period of at least 45 days (for non-preference shares) These provisions are designed to counter manipulation of the imputation system. The requirement to have held the shares 'at risk' ensures that, for example, attempts to stream franking credits to persons who have been assigned the right to receive dividends, without undertaking any risk in the downturn in underlying share price, will be caught by the provision. See further *Tax Determination TD 2002/32*. While this provision does not necessarily cause there to be a loss of franking credits to the entity paying the dividend, it denies shareholders the benefit of the credits and operates as a further restriction on attempts by investors to take the benefit of accrued franking credits.
Schemes involving franking credit trading or dividend streaming (s 177EA ITAA36)
This section empowers the Commissioner to impose franking debits or exempting debits (and therefore causes a company to forfeit franking credits) where a company streams distributions so as to provide franking benefits to members who benefit more from franking credits and rebates than other members. The section was introduced as a 'catch-all' provision to counter franking credit trading and dividend streaming schemes, similarly to Subdivision 204-D above, except that it requires the existence of a scheme for disposal of shares (or interests therein) involving franking credit trading and/or dividend streaming with the purpose of obtaining a franking credit benefit. The measure specifically targets trading schemes which allow franking credits to be inappropriately transferred (such as by allowing credits to be accessed by those

Effect of provision
who do not bear the economic risk of holding the shares).
Tainted share capital accounts
Companies are permitted by s 254S of the *Corporations Act 2001* to capitalise their profits. If it does so, it may be able to distribute amounts to shareholders in a tax-free or tax-deferred manner. The share capital tainting rules are designed to prevent companies from capitalising by transferring amounts to their share capital account and subsequently making tax-free or tax-deferred distributions. **Tainting transfers** (s 197-45 ITAA97) Division 197 applies to amounts transferred to a company's share capital account from any other account of the company with some exceptions. One of the effects of Div 197 for tainting transfers is that a franking debit will arise in the company's franking account. **Untainting elections** (s 197-65 ITAA97) Upon electing to untaint a share capital account, a further franking debit will arise in the company's franking account if the benchmark franking percentage for the franking period in which the transfer occurred is less than the benchmark franking percentage for the franking period in which the untainting choice is made.

4 Observations from my experiences in advising on corporate distributions

In my 14 years of practice in Australian income tax law, I have had cause to advise companies on all manner of income tax considerations in planning their business affairs. Frequently the discussion concerns questions of capital management and gearing, with the follow-on question of returns to the holders of the debt and equity interests in the company, as well as questions emerging from M&A activity.

Professor Handley's comment is reproduced below:

> *"It is unreasonable to assume that such a build up of credits would not (eventually) attract the attention of investors, investment bankers and or potential corporate raiders. Further, when assessing the likelihood of eventual distribution of retained imputation credits, one should not restrict their thinking to existing mechanisms, schemes, structures and securities, for history has shown that financial markets are highly innovative when the incentives are large."*

This comment focuses on the financial incentives of "investors, bankers and or potential corporate raiders" to extract franking credits from corporate structures and therefore monetise those credits. In my view this is only one aspect of the considerations which go to the overall capital management strategy of a business and the returns provided to holders of equity and debt. For example:

- The value that company boards and their shareholders place on franking credits depends on a number of considerations, including:

(a) The profile of the majority and minority shareholders. For example, companies that are resident in certain jurisdictions such as the US or UK may not have any interest in franking credits if they can access 0% rates of withholding tax under the relevant Double Taxation Agreement.

(b) The investment focus of shareholders. Some shareholders will be interested in yield, whereas others have a preference for capital growth. The discount capital gains regime may be a relevant driver of decision making in this regard.

(c) The growth strategy of the company itself, in terms of re-investment and gearing considerations. This is discussed further below.

It is quite conceivable that as certain companies that do not distribute their franking credits because of the desire to re-invest, or because of a lack of interest from shareholders in receiving franked dividends, that those companies will be exposed to events in the longer term which cause those accrued franking credits to be lost. For example, a company that experienced rapid profit growth (and generates franking credits from the taxes paid thereon) followed by sustained losses in the course of a financial crisis may generate a store of franking credits which cannot be effectively distributed because there are no profits remaining to which the franking credits can attach or, one or more of the special franking integrity rules noted earlier in this paper could have the effect of causing franking credits to be lost.

- I have had cause to consider the position of companies which, while carrying significant retained franking credits and reserves, due to changes in the capital requirements of the business (eg. requiring the raising of additional debt), it is not appropriate commercially to distribute those reserves and, where that company is subject to Australian thin capitalisation rules, distribution may cause a denial of interest deductions.

- Raising debt to access additional funds to replace a reduction of working capital caused by the payment of franked dividends could, all things being equal, result in the entity increasing its gearing beyond the 60/40 assumption made by the AER in its Statement of Regulatory Intent. Retention of profits to preserve a gearing ratio of 60/40 would necessarily result in the accumulation of franking credits with respect to that pool of profits. It is difficult to say that these profits would eventually be distributed.

- A common component of my practice is advising on mergers and acquisitions. The shareholder profile of a company often changes considerably after a deal takes place, sometimes causing the accrued franking credits of the target to be unavailable for use by the purchaser. For example, a company sold by a non-resident to an Australian acquirer would not be eligible to effectively pass on any of the franking credits generated by the target company. Those franking credits are effectively quarantined (in an "exempting account").

- Troubled businesses and corporate groups often have profitable operations isolated within certain group members. In such a situation, the profitable entity may well be a target for another group. However, if the purchaser acquires the profitable entity in isolation without acquiring the company, or in the case where a company is acquired which is a member of a consolidated group, the head company of that consolidated group is not acquired, any franking credits previously generated by that business or company remain with the company or the head company as the case may be. If that company or head company are unable to recover to a point where they are generating profits and worse, are placed into liquidation, those franking credits are at a practical level lost forever.

The above are examples which have either directly affected my clients or circumstances which I could envisage arising, particularly in the context of the current global economic uncertainty within which companies find themselves.

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Schedule 1 — Curriculum Vitae of Peter Feros

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Peter Feros joined Gilbert + Tobin in October 2008, as a tax partner. Prior to joining Gilbert + Tobin, Peter was a tax partner in a Big Four Accountancy Practice.

Peter has over 13 years experience in advising Australian listed and foreign multinational companies on Australian corporate taxation. Peter has diverse industry expertise, including the telecommunications, technology, entertainment, media, consumer product, industrial product and property sectors.

Recent transactions Peter has advised on include:

- Advising on income tax relating to mergers and acquisitions, due diligence, and structuring
- Advising on the income tax consequences of a significant joint venture infrastructure project
- Advising on income tax advice in relation to in-bound and out-bound cross border structuring
- Advising in relation to the income taxation issues associated with property and infrastructure funds
- Advising on the operation of the imputation regime, including the operation of the benchmarking, streaming and 45-day rule provisions
- General corporate tax advice, including:

    significant tax consolidation projects

    capital gains tax

    tax loss utilisation and management

    advising on the operation of the debt/equity provisions of the tax law

    conducting tax risk management and strategy reviews

Peter holds a Bachelor of Laws and Bachelor of Economics (obtained from Macquarie University) and a Master of Laws (obtained from the University of Sydney).